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ABSTRACT

Designed for high school economics students as a public service project of the American Fletcher National Bank, the booklet examines the heavy burdens placed on our political-economic system and compares our economy to an overloaded electrical system about to "blow a fuse." In the last two decades, America has become a self-indulgent society which demands more from society than it is capable of giving. Some pressures are: (1) the American view that jobs are an entitlement; (2) the belief that Americans are entitled to real growth in personal living standards; (3) the decline in productivity; (4) the belief that Americans are entitled to government support, resulting in increased dependency on Social Security, unemployment compensation, and other benefit programs; (5) the channeling of profits into environmental and regulatory programs rather than into future investments; (6) an increasing dependence on imported oil, resulting in increasingly higher energy costs; and (7) the ever-increasing burden of keeping up with the Soviet Union in defense. Americans can ease these pressures by first slowing down the pace of nonessential and credit buying. Second, there must be a voluntary slowdown in wage and price demands. Third, Americans must reduce their demands on government and stop driving the country into continued deficit spending and finally, we must accept slower rates of economic growth at the personal and corporate level. (LH)

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FUNDAMENTALS OF FREE ENTERPRISE

No. 6

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American Fletcher National Bank and Trust Co.
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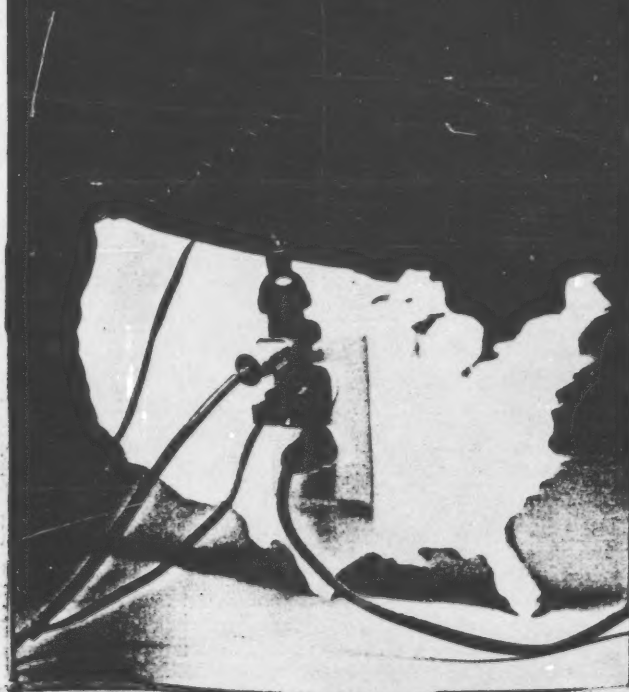
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THE AMERICAN ECONOMY

A fuse
about to blow?



Probably every American family has experienced, at one time or another, a blown electrical fuse — that minor annoyance which occurs when more demand is placed on the home's electrical system than it was designed to carry.

The parallel is not exact, but an increasing number of economists, financial analysts, and social scientists are suggesting today that something comparable is threatening the American economy. We may be placing heavier burdens on our political-economic system than it can cope with at one time; many Americans fear we could "blow a fuse" if some of the pressures are not relieved.

There are many symptoms that something has gone awry: a persistent inflation that hovers near the double digit level year after year . . . rapidly fluctuating interest rates . . . housing costs running beyond the

affordable level for many . . . persistent unemployment . . . the value of the American dollar wavering in foreign markets . . . all these and more are threatening the so-called "American Dream."

The traditional optimism of many Americans has been shaken, and there is skepticism that the future will be better than the past. Why?

The possible explanations — and there are many — could add up to a simple thesis that over the last two decades America has become a self-indulgent society which demanded more from our economy than it is capable of delivering.

It seems the old notion of America as the land of opportunity — where people had the freedom to work out much of their own economic destiny — has been replaced by America, the land of obligation, where the "system" has been given

responsibility to provide economic security for everyone.

Sociologist Daniel Bell even introduced a new expression into our vocabulary to describe the phenomenon:

"What is clear is that the revolution of rising expectations, which has been one of the chief features of society in the past twenty-five years, is being transformed into a revolution of rising entitlements for the next twenty-five . . . They are not just the claims of minorities, the poor, or the disadvantaged; they are the claims of all groups in the society, claims for protections and rights — in short, for entitlements."

Ultimately, all this burden comes to rest on the back of the so-called private business sector, because it is the basic source of our national wealth. One textbook puts it this way:

"The business system is the heart of the American economy. To begin with, it

pays a walloping share of taxes. More importantly, it pays payrolls to employees who, in turn, pay taxes and who also, in turn, support the grocer and the baker and the doctor and the dentist, who pay taxes . . . Those taxes paid by business organizations, and by people on the payrolls of business organizations, provide the support for the so-called public sector. Without the private sector and the economic chain of events it puts in motion, there would be no funds to support a public sector."

What the textbook assumed but did not mention is that business profits are essential to make it all happen. Without profits, there would be no business — hence, no payrolls, no taxes, and no funds, public or private, to pay the cost of these "entitlements."

What are these expectations that have been loaded onto the "system" — some of them

mandates imposed by legislation, others simply nagging demands pressed by assorted special interest groups? Here is a partial list:

1. *A Job for Everybody, to Have and to Hold* — By most measurements, the economic system has performed admirably over the last decade in creating and maintaining jobs for a growing population. For example, there were 20.7 million more Americans employed as the decade of the 1970's came to a close than were working when it opened. The unemployment rate of 5.8 percent for '79 was even lower than the 6.2 percent average for the whole 10-year-period.

Nevertheless, Congress has determined that the track record of the 1970's isn't good enough. Because of the new Humphrey-Hawkins Bill, the President is now mandated to press for a 4 percent unemployment rate by 1983.

Many observers, aware that such a low figure has been achieved briefly only twice before in this century, believe the goal is unrealistic. The 4 percent goal remains, however, and it is yet to be seen whether the economy can generate the new jobs to accommodate the 25 million younger Americans who will enter the job market during the 1980's.

Perhaps even more troublesome for American business is the growing notion that a new job, once created, is something of a property right. As business analyst Peter Drucker has noted, "In every developed non-Communist country, jobs are rapidly turning into a kind of property . . . There is even growing pressure (in the United States), including a bill before Congress, to make the employer responsible for finding the employee an equivalent job in the event of a layoff."

A job, therefore, is being viewed as a new "entitlement," to which every American can stake a claim, regardless of economic circumstances.

2. *Real Growth in Our Personal Standard of Living*—A superficial look at the 1970's might persuade many Americans that the nation experienced significant economic growth — and that they prospered from it enormously. But outward appearances can be deceiving.

Real economic growth is the only way Americans can achieve a higher standard of living without reducing the level of living for someone else. Achieving it requires increasing both per capita income and purchasing power from year to year.

Real economic growth also requires a percentage change in the Gross National Product (GNP) — the value of all goods and services produced — that is greater than the

percentage change in average prices.

There were some increases in GNP and personal purchasing power in the 1970's — but not as much as raw figures might suggest.

From 1974 through 1979, for example, the GNP grew from \$1.4 trillion to \$2.4 trillion — a deceiving average *annual* increase of 10.4 percent. With inflation (as reflected in the Consumer Price Index) factored out, the *real* increase was only from \$1.2 trillion to \$1.4 trillion — an average real growth of only 2.4 percent per year.

Meanwhile, over the same period, personal disposable income — what's left to spend after taxes — increased by an average of 10.3 percent a year. Perhaps lost in the excitement over those fatter paychecks was an average annual inflation rate of 8.5 percent, which meant that the *real* increase in purchasing power amounted to less than

2 percent a year.

Nevertheless, Americans apparently believed they were better off than they really were — because they went on a spending binge in the 1970's. Not only did they spend almost everything they made, they plunged ever deeper in debt to obligate much of their future income, too.

At one point in 1979, total private debt in the country reached \$420 billion, and consumers found themselves parting with nearly one-fourth of their disposable income each month to pay off consumer loans.

Perhaps Americans would have taken all that debt in stride except for one predictable development which made 1979 a benchmark year. Suddenly, the inflation rate got out of control and increased much faster than wages. The year ended with an average 13 percent increase in prices for

the year, matched against only an 8 percent increase in wages. For the first time in nearly two decades, Americans found themselves *losing* purchasing power — perhaps unaware that their own spending spree had triggered so much demand that dramatic increases in prices would be inevitable.

As Americans entered the new decade, they were beginning to learn that, in their zeal to push their living standard ever upward, they perhaps had pressed too hard and had unknowingly contributed to an inflation that was making all those wage increases meaningless.

3. *Profits Adequate for Present and Future Payoffs*—American business is being squeezed from several sides at once where profits are concerned.

From one side comes the protest of millions of consumers who object to rising prices because they

want their own disposable income to keep ahead of the Consumer Price Index.

From other angles, however, come the pressures of investors wanting bigger dividends and employees expecting to earn more — and neither possible without increased corporate earnings.

It is a vise of gigantic proportions, made all the more confusing because the clash of interests brings out raw selfishness in interesting ways.

As employees or investors, we want our own firm to profit, even if it means raising prices. But as consumers, we don't want to see other suppliers and vendors raise their prices because it cuts into our disposable income.

A hidden culprit in the dilemma is the issue of productivity, a measure of how much it costs to produce goods versus the ultimate value of them in the marketplace.

With increases in productivity, no business would need large increases in prices; large volume and greater production efficiency would produce the profits necessary to bolster dividends and higher wages for employees.

But productivity has been increasing at a steadily slower rate in the United States for at least a decade. Thus, the revenue necessary to meet higher dividend and wage demands has had to come from higher prices.

For the 25 million Americans who have invested in the stock market as a cushion against inflation, higher dividends are especially important in their attempt to preserve purchasing power.

This short-range payoff is equally important to additional millions of older citizens, whose pension funds often are invested in common stocks.

Beyond satisfying the present need for wages and dividends, earnings also are supposed to provide the capital necessary for the future — through investment in new plant and equipment and in research to improve productivity and create new jobs.

The United States has clearly fallen behind world competitors in capital investment, which helps explain why American productivity increases have been much smaller than in countries like West Germany, Japan, and France. Many economists believe the U.S. should be investing 15 percent of its national wealth in capital expansion each year; instead we are investing less than 10 percent. Some estimate the price tag of needed projects such as new factories, machines, transport systems, and alternative energy forms to be in excess of \$200 billion — a staggering

expenditure that present profit margins simply will not allow.

4. *Support of an Ever-Growing Government*—The "system" also bears the enormous weight of an ever-larger role for government in our lives, especially at the national level.

Twenty years ago, 23 percent of the GNP was used by federal, state, and local governments for their purposes. That figure has soared to the 33 percent level today — which means that one of every three dollars generated by the GNP now is drained away in taxes.

Dependence on the government has grown so markedly in American society that nearly 125 million Americans — 56 percent of the population — are now directly dependent on tax dollars for at least part of their income.

Forms of income support known as transfer payments

— for Social Security, unemployment compensation, and various benefit programs — are now devouring nearly \$300 billion a year in the federal budget. These funds go to about 65 million people — about 30 percent of the population.

The burden will become heavier during the 1980's, with the number of persons over age 65 — thus eligible for Social Security — increasing by 20 percent to 41.7 million.

Another concern is the burgeoning government payroll. Government is now the country's biggest employer, according to former Secretary of the Treasury William E. Simon. He says one of every six workers today is employed by government at either the federal, state, or local level — more than all the people who work in the auto, steel, and other durable goods industries combined.

5. *Paying the Environmental and Regulatory Tab*—Regulating business is one of the fastest-growing areas of government, and the private sector is now spending nearly \$70 billion a year to comply with the fine-print regulations of assorted federal agencies.

A Washington University study shows that federal payrolls for regulatory agencies has reached the \$5 billion dollar level. But in compliance costs, American industry is now spending almost \$65 billion annually in new equipment and procedures.

While few deny the need for some federal standards and regulations, many observers contend the benefits of these programs are not worth the price.

The Environmental Protection Agency estimates that America is now spending about \$35 billion yearly to minimize air and water

pollution and predicts expenditures will probably remain at that level over the next decade.

According to the EPA, industry is paying 51 percent of the anti-pollution bill, the government about 13 percent, and consumers about 36 percent. The misnomer in that formula is that government has no money of its own and could not produce its 13 percent "share" without taxes collected from both industry and consumers.

Some of these costs are being passed on to consumers in higher prices. Thus, there are estimates that compliance with air pollution standards — to cite only one item — has added nearly \$1,000 to the price of a new car over the last 10 years.

Many of the expenditures, however, cannot be passed on in higher prices. Industry must spend the money out of profits that might otherwise be reinvested in new plant and equipment.

6. *Absorbing Higher Costs of Energy*--The American economy also is trying to support the public's ravenous appetite for energy consumption, especially the high cost of imported oil.

Oil consumption in the United States has tripled in the last 30 years to the present rate of 18.9 million barrels a day. Because domestic production cannot keep pace with that soaring demand, America is now importing 43 percent of its oil at a price now approaching \$30 a barrel. As a result, approximately \$72 billion is leaving the United States each year for imported oil alone.

Imported oil is the No. 1 reason that the American economy is *losing* nearly \$30 billion each year in balance of payments — the difference between what we receive for our exported products and what we pay out for our imports.

One noted economist, Walter Hoadley of the Bank of America, believes America's excessive reliance on oil imports — particularly those from the volatile nations of the Middle East — could be the leading threat to the American economy over the next decade.

Hoadley contends each 10 percent increase in the price of imported oil means at least a one-half percent increase in the country's inflation rate, and a decline in real economic growth.

7. *Financing the Defense of the Free World*—Finally, there is the problem of maintaining a defense establishment to deter would-be aggressors. America is now spending upwards of \$100 billion each year to equip and maintain 2.1 million people in the military.

It is a burden from which there can be no retreat — not as long as the Soviet Union spends \$140 billion annually

to maintain armed services of 4.7 million, and invests three times as much as the U.S. in nuclear weapons.

All these demands — some thrust upon us from without, but most developed from within — have left the American economy in a state of shock — much like a battered prizefighter who wonders how many more punches he can withstand.

Perhaps no one has summarized the problems more succinctly than *Time* magazine essayist Marshall Loeb:

"In the current indulgent decade, the U.S. has spent too much and saved too little. It has spent too much of its wealth on immediate gratification and too little on investment for the future, too much on easy imports of energy from afar and not enough on hard-slogging development of energy at home. The consequences have been turgid productivity, leading to

low economic growth; high budget deficits leading to inflation; multiplying balance of payments deficits, leading to a weak dollar, which in turn reduces capital investment from abroad and holds back the expansion of jobs and real income."

How do we climb out of this self-made quagmire? How do we reverse a tide set in motion many years ago that now threatens to engulf us?

There are no simple, quick-fix solutions, but there seems to be an emerging consensus that present patterns cannot continue indefinitely without the whole political, social, and economic fabric coming apart at the seams.

Sentiment is building for four steps Americans can take to ease the pressure on the economy.

First, Americans must slow their pace of buying and stop digging themselves ever-deeper into debt.

For nearly four decades,

social scientists and politicians have been quibbling about the importance of mass consumption to the American economy. It is painfully obvious that if the public doesn't buy the products of American industry, inventories will pile up, factories will slow production, and workers will be laid off. The economy will stagnate.

Indiana statesman Wendell L. Willkie was one of the first to make the case for mass consumption. After returning from a world tour in the 1940's, Willkie wrote, "The American economy is not going to be able to prosper unless Americans regard as necessities what other people look on as luxuries."

Economist John Kenneth Galbraith has been the most vocal spokesman for another school which laments the emphasis on mass buying. Galbraith has complained for three decades that American

industry fosters "frivolous desires" through advertising that encourages people to buy what they really don't need.

In recent years, Americans may have taken the Willkie philosophy too literally. They have seen *every* new product as a "necessity" which they must have now, even if the income won't justify it and they must plunge into debt to acquire it. This insatiable demand for more credit has been met by Washington, where the printing presses have consistently produced more new money than our *real* economic growth would justify. These cheaper dollars have fueled a vicious cycle of wage and price increases and a sharp inflationary spiral.

There is a growing evidence that consumers are beginning to "cool off" the economy by cutting back on non-essential buying, especially buying on credit.

A slowdown in buying also would help relieve a steady

erosion in personal savings. Americans are now saving only 3.3 percent of their income annually, one of the lower rates in the world. Increasing the savings rate could help meet necessary credit demands and slow the infusion of cheaper dollars from those presses in Washington.

Second, there must be a voluntary slowdown in wage and price demands. If the country is to avoid mandatory wage and price controls as a method to curb inflation, both workers and their employers will need to exercise moderation in the future. Employees will need to accept smaller wage increases, and companies will need to accept lower prices for their goods and services.

Glenn Watts, president of the Communications Workers of America, has suggested that American workers will need to accept wage increases over the next decade that run at least 2½ percent lower than

price increases. His fear is that larger pay increases will prompt still more inflation.

Others suggest that wage increases should be tied to actual increases in productivity. This suggestion stems from the fact that many workers in recent years have been demanding — and getting — pay hikes larger than increases in their productivity. Companies have simply passed on those costs to the American consumer in higher prices. These, in turn, have set off a new wave of wage increases, and a vicious cycle has resulted.

Third, Americans must reduce their demands on government and stop driving us into continued deficit spending.

Columnist George Will has summarized the situation in these words: "The problem, I believe is quite clear. We have as a democracy a voracious appetite for public services and a negligible willingness to pay for them."

Will is but one of a chorus of opinion leaders who are suggesting that Americans must learn to do more for themselves and stop turning to government for various forms of aid.

Because we have demanded far more than we have been willing to pay for in taxes, Americans have pressed the concept of deficit spending to near disastrous limits. Consequently, the federal government has spent more than it has received in 19 of the last 20 years, and the public debt is now approaching \$900 billion.

Finally, Americans will need to accept slower rates of economic growth at both the personal and corporate levels.

According to *New York Times* columnist James Reston, "Americans have become too used to life getting better by 5 or 10 percent each year. No society in history ever experienced such growth. We are spoiled rotten."

Corporate executives must stop believing they are failures if they don't generate annual profit increases in the 7 to 10 percent range.

Similarly, workers must stop feeling exploited if their wages don't go up every year by 7 to 10 percent. Both sides must start lowering their expectations to more reasonable levels — to approximate more closely *real* increases in volume, sales, and profits.

These four steps are not the total solution, of course, but if the majority of Americans could accept them, much of our current economic chaos could be eliminated.

Pessimists have already concluded that the American people have become too pampered to swallow this bitter medicine. They are already writing off the United States as a bankrupt society, both spiritually and economically.

They are taking their skeptical cues from a 17th-

century British historian, Alexander Tytler, who wrote:

"A democracy cannot exist as a permanent form of government. It can only exist until the voters discover they can vote themselves largess out of the public treasury. From that moment on, the majority always votes for the candidate promising the most benefits from the public treasury — with the result that democracy collapses over a loose fiscal policy, always to be followed by a dictatorship."

Optimists, on the other hand, are not ready to accept this fate. They consider the present dilemma merely a repetition of economic problems the United States has faced before — and conquered.

Exactly one century ago, for example, it is interesting to note the dilemma which faced President Rutherford B. Hayes as he prepared for his last year in office:

... skyrocketing inflation
... the value of the dollar
falling rapidly in foreign
money markets ... charges
across America about
wasteful and extravagant
spending by government ...
complaints that the tax
structure discriminated
against the middle class ...
grassroots demonstrations
against the high profits and
soaring prices of natural gas
companies ... even a
movement by some groups to
have America adopt the
metric system!

The United States obviously solved those 19th century problems and moved on to brighter, more prosperous days.

Whether that same happy scenario will be written again in the closing years of the 20th century remains to be seen. The answer ultimately lies in the collective wisdom, courage, and commitment of the American people.